RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Dec. 31, 1996 **LETTER 1216**

THE MARKET: As this is written both the Dow and the S&P 500 are at all-time highs (the Dow recorded an incredible 45 new record highs in 1996). The Transports continue to lag, and are now actually below their peak of last May 2 (in case you forgot, the May 2 peak of 2296.20 was the previous record Transport high, a high that was finally bettered on November 20).

Oops, another stock market warning (*WSJ*, Dec. 30, front page article) on the mutual funds and the pressure on their managers to stay FULLY invested.

PTI: I want to talk about my **Primary Trend Index** (see page 2 chart). I developed this Index during the middle-'60s, and, beginning in 1971, I included a chart of the PTI in every Letter.

The PTI provides us with a daily picture of the underlying strength or weakness of the market. By construction, it's technically impossible for the PTI to rise on a trend basis without taking the rest of the market with it. Conversely, it's impossible for the PTI to decline on a trend basis without taking the market with it.

I guess the most interesting observation I can offer (and I called attention to this in the last Letter, see chart on page 2) is how grudgingly the Primary Index backed off from its November 25 high. Then on December 20 the PTI rose to a new high. In other words, although the stock market took a beating for a few weeks, the PTI hardly noticed the weakness.

So let me put it this way -- the pattern of the PTI tells me that the technically strong moves in the market are still on the upside while the technically weaker moves are still on the downside. When this type of action changes, it will be highly significant.

MARKET ACTION: From the November 25 high of Dow 6542.79, it took 15 trading days to the December 16 low of 6268.37. Then in four days of trading the Dow was back almost to the high. In a **bear market** the **longer, extended** moves are to the downside, while the upward corrections tend to be explosive, often making up in a **few days** what it has taken a few weeks or even a few months to accomplish on the downside. This description would seem to fit the market action that we've experienced since late-November, but wait -- it's just a straw in the wind, and certainly not conclusive indication of the beginning of a bear market (see chart of the Dow on page 2).

OBSERVATIONS: First, a question -- "Is this market really expensive?" To answer that question, I'm going to use the following quote from *Hussman Econometrics* [(800) 487 7626]:

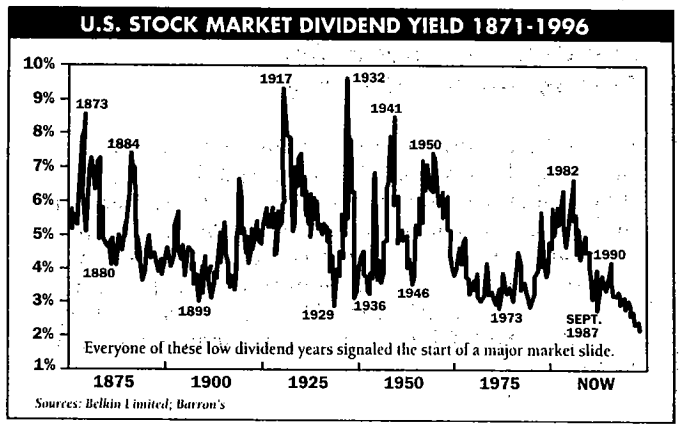
"The price/earnings ratio on the S&P Index is currently 21, this on the basis of *record earnings.* Historically, when the

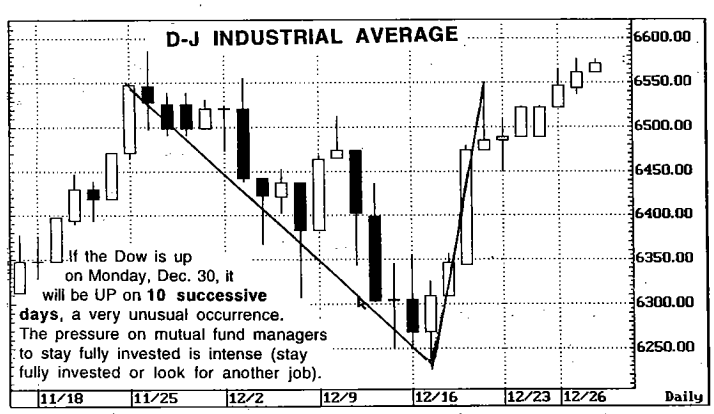
Dec. 20 DJIA 6485.94; PTI 4743; A-D Ratio +2.48
Dec. 27 DJIA 6560.91; PTI 4761; A-D Ratio +2.95
Dow Yield: 2.02%; Dow Price/Earnings: 19.0
Dow 144-day MA: 6172; Dow 34-day MA: 6440
Dow Times Book Value: 4.90; PTI 89-day MA: 4675
Percentage of Undervalued Blue-chips: 4%
Gold 200-day MA: 386.90; Gold-PTI: 217

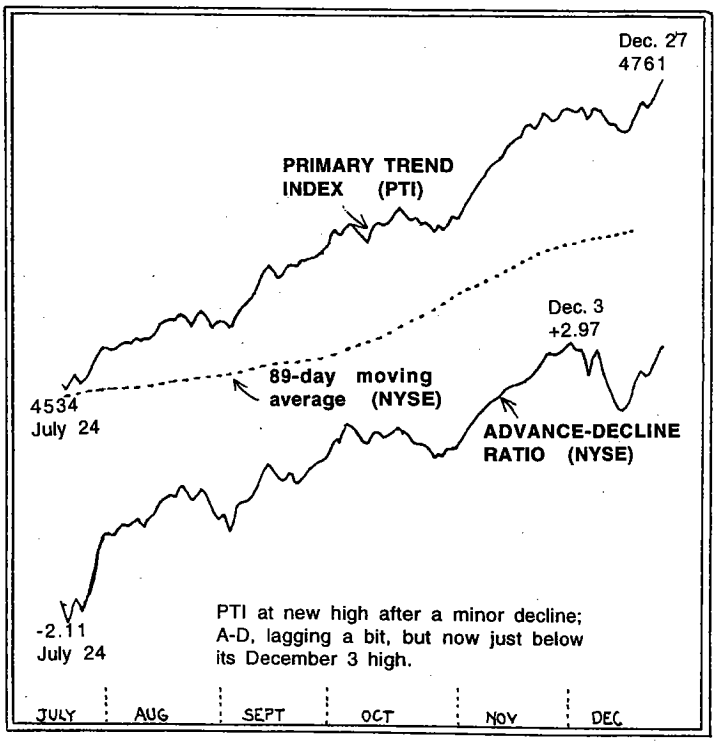
P/E ratio has been above 20, it has always been because earnings were depressed -- more than 24% below their highs, on average. Indeed, there are only two times in this century when the P/E was even over 19 on the basis of record earnings. The first was early 1964: stocks earned a total return of just 1% annually over the following decade. The second was late 1972: stocks quietly entered a bear market which took prices down 48%, and even a decade later, the total return on the market had averaged just 3.2% annually." **Russell comment:** If you don't accept the "low dividends are dangerous" argument (and a lot of people don't), you might concentrate on the above which deals not with dividends but with earnings.

The statistics on the **S&P Industrial Index** are "out of this world." The yield has shrunk to 1.84% while the Index is selling at an incredible 5.35 times book value. Finally, the price/earnings ratio is 23.22. In all, a group of stats to show your grandchildren.

Dividends may not mean anything here in the '90s, but if so, over a hundred years of history are worthless. This chart shows dividend extremes for the market going back to







1871. Note that every one of the extremes on the mini-yield side led to a bear market. But the market is never without its foolers. The fooler this time is that average yields dropped to their lowest level in Wall Street history -- below 2% instead of the more usual below 3%.

Of course, mini-dividend yields do not act as a timing device. Minuscule yields simply warn that the market is on thin ice. Unfortunately, they just don't tell us HOW THIN the ice is (no technical or fundamental system will tell us that).

Next question: "How strong is this market?" Up to now it's been very strong. One test of strength which I discussed is the action of my Primary Trend Index (PTI) which, so far, has been very reluctant to decline.

A third test is suggested by the following quote from Norm Fosback of *Market Logic* out of Deerfield Beach, FL: "The one-and-one-half month period starting two days before Thanksgiving and ending with the fourth trading day in January has *impressively accounted for 40% of the market's entire price return over the last 70 years."* **Russell comment:** Amazing, and shows how important the current December period is. In other words, we are now in the period where, historically, the stock market has put on its best performance. So, if the market can't put on a good show between now and the fourth day of January, it will be an indication that something is wrong. In which case -- it will pay to be very careful.

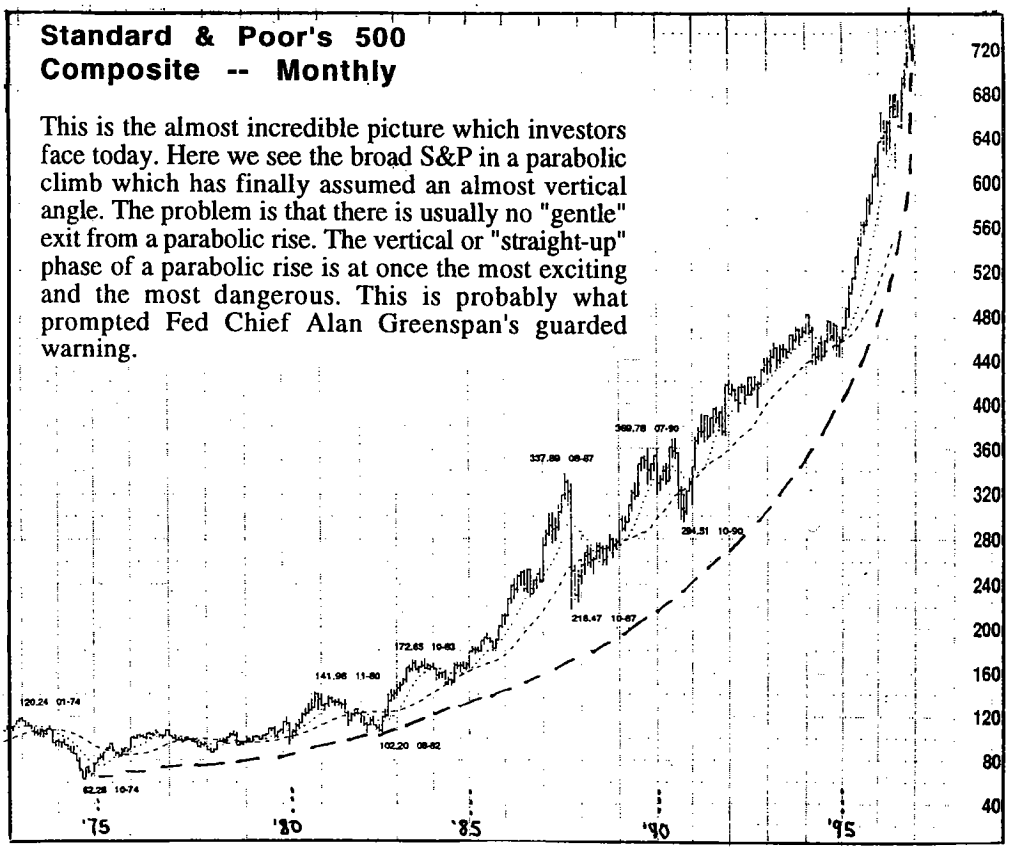
Fourth question: "Where is the current stock market in the great scheme of things?" In answer to this one, I'm showing the extraordinary (at least I think it's extraordinary) chart on **page 2.** Here we see the S&P 500 Stock Average in an explosive multi-wave rise.

This first up-wave began in 1982 and ended with the great crash of 1987. The second up-wave began from the 1987 low and carried to 1990. The third and most dynamic up-wave began in 1990, hesitated a bit during '94, then continued to its latest segment -- a rise which has accelerated almost to the vertical.

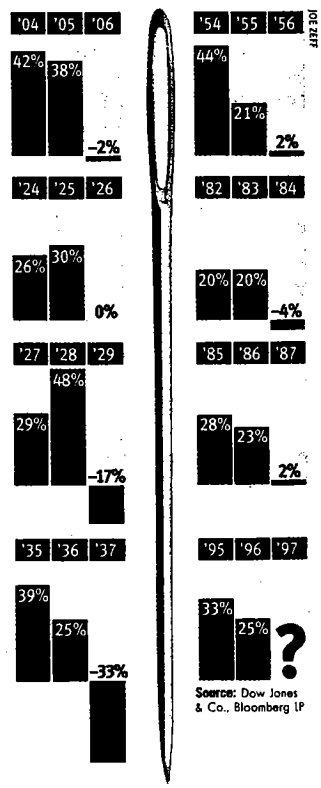
The whole picture is that of an average which has assumed the form of a parabola. The parabola is a formation which starts up slowly, continues to build, and finally surges almost straight up. The path of a parabola can usually be traced with a drafting instrument known as "a French curve."

Standard & Poor's 500 Composite -- Monthly

This is the almost incredible picture which investors face today. Here we see the broad S&P in a parabolic climb which has finally assumed an almost vertical angle. The problem is that there is usually no "gentle" exit from a parabolic rise. The vertical or "straight-up" phase of a parabolic rise is at once the most exciting and the most dangerous. This is probably what prompted Fed Chief Alan Greenspan's guarded warning.



Since 1900, whenever the stock market has gained 20% or more two years in a row, the third year has been a bust.



Source: Dow Jones & Co., Bloomberg LP

One important point about parabolas is that they almost never end gently. Once the vertical segment of a parabola tops out, it's an indication that the upside energy has been exhausted. When this happens, one can expect a major, but often erratic decline, and it doesn't matter whether we're talking about a stock, a commodity or a stock average.

In view of the above discussion, I am asking my subscribers to study this S&P chart carefully -- it may be the most important chart of this year -- or for the next decade for that matter.

Another study that deserves our attention is shown on this graph from *Money* magazine (chart bottom right of page 2). There have been seven times in history where the market has gained 20% or more over two consecutive years. When this has occurred, the third year has never been a good one, and on a few occasions (1929, 1937) the third year has been extremely costly. The year 1997 will be another third year following two "better than 20%" up years. So let's see if the historical pattern will hold or be broken in '97.

In the meantime, we'll watch the market on a day-to-day basis. The old Indian adage tells us, "To walk a mile, you must take a first step." By the same token, to start a new trend, the market has to record that first day of reversal.

Further Comments: Talk about defying the odds, ponder the following from *Stockmarket Cycles* [(707)579-8444]: "Since 1901 the average maximum Dow decline during EACH year was 16.9%. In other words, in every year since 1901 (up to 1985) the Dow declined at least 16.9%. But since 1985 we have seen only one year, 1990, in which the Dow suffered a decline (closing basis) of as much as 10%. And since 1990 the Dow has not gone through a year with as much as a 10% decline on a closing basis. Incredible."

Now here's an observation, one that I don't think you'll see anywhere else. The last time the Dow closed below the low of a preceding year was 1977. In other words, the Dow hasn't had an actual "down year" in the last 19 years! If you believe in probabilities, that's a fact that might make you a bit nervous. Also, 19 years of a higher Dow has clearly generated a great deal of confidence (particularly among mutual fund investors). This may explain why the market is now in a parabolic rise.

Sentiment: How bullish are people today? I thought this was an interesting example. Mr. Larry Kimbell, director of the UCLA Business Forecasting Project, states, "A decent collapse in the stock market would be nice right now. We need a break for a change." **Russell comment:** Of course I differ with the good director. With 30,000 investment clubs plus tens of millions of people now invested in the stock market, a market crash would hardly benefit the economy. Furthermore, the director has been greatly influenced by the 1987 crash. That crash was over in a few months. A crash followed by an extended bear market would be an entirely different animal. But I guess that eventuality has never occurred to director Kimbell.

Market crash 'would benefit US economy'

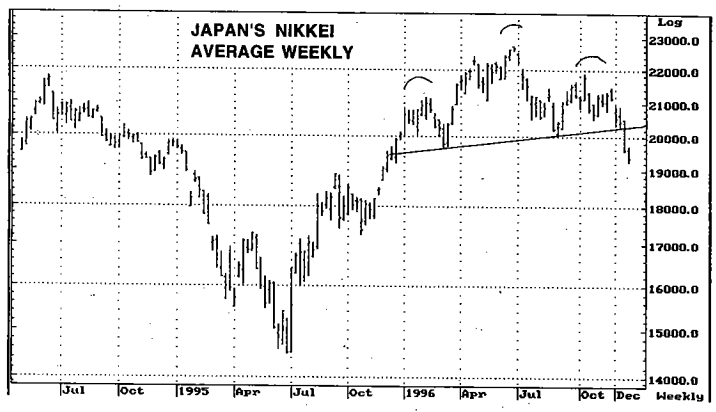
By Christopher Parkes in Los Angeles

A US stock market collapse would probably do the US economy more good than harm, according to the latest forecast from the University ing to recent gentle warnings of "irrational exuberance" from Mr Alan Greenspan, head of the Federal Reserve, and noted the hint was a reminder "that there is no such thing as letting sumption spending was in line with real gains in disposable incomes.

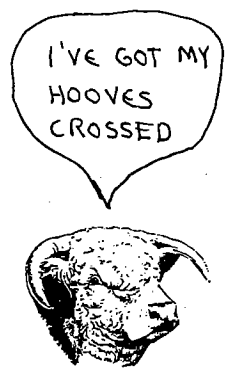
Real growth in gross domestic product slowed from an "unsustainable" 4.7 per cent to a "healthy" 2 per

The great Japanese "bubble market" topped out on December 29, 1989 at 38,915. A vicious bear market ensued, which saw the Nikkei collapse to just over 14,000 in mid-1995 (this wiped out over 60% of Japanese stock values). In 1996 the Nikkei advanced to above 21,000, but last week, on December 29, the Nikkei again sank below the critical 20,000 level.

Here's a chart of Japan's Nikkei stock average. The Nikkei has just completed a "head-and-shoulders" top pattern, which tends to be a reliable indication of distribution. Japan has been a major buyer of US Treasury bonds, and I wonder whether Japan's buying proclivities won't be affected if their stock market starts down in earnest again.



INVESTMENT POSITION: The year 1997 will be a most fascinating year for any number of reasons. Here are a few of the reasons: **(1)** The first year of a president's second term is often a rough one for the market. This is because in his second term the prez has to get down to serious business -- he's not running for office, he's running for history. **(2)** 1997 is a "7" year in the decennial pattern, and 7-years have not tended to be good ones (for instance, '17, '37, '57, '77, '87). **(3)** Two back-to-back years in which the market has gained 20% or more in each year -- have never been followed by a good third year. **(4)** Minuscule stock yields have not been a good omen for the market. Stock yields are now at record lows. **(5)** The Dow has not had a 10% correction since 1990. **(6)** The Dow has not had a "down year" in 19 years, since 1977.



Ah yes, but all the above are facts or probabilities based on history. But remember -- probabilities don't run the stock market, reality does. And for this I have my Primary Trend Index. The PTI doesn't give a damn about yields or past performance, and it couldn't care less that we haven't had a down year in the Dow since 1977. The PTI, in its emotionless, remorseless way, traces out the actual underlying action of the market. The action of the PTI, up to now, has been bullish. When that changes, you'll know it and I'll know it.

NOTES & QUOTES: The advisory or newsletter business has never been easy, but I feel it's more difficult today than at any time since I've been in the business. Many of the newsletters of the '60s and '70s are gone; either the authors have died or their reports have just faded away for lack of subscribers. Last week I was sorry to hear that Bob Nurock (an original Wall Street Week "elf" and a

veteran letter-writer) had quit the business. And that's a shame, because Bob wrote a fine report. Me, I just keep going. "Staying power," it's important in any endeavor, and particularly important and tough in this business where no one is right more than, oh, I guess 60% of the time.

* *

Business Week polled 45 leading market people regarding their Dow forecast for '97 (i.e., at what level the Dow would end next year). The poll showed that 15 participants thought the Dow would close over 7,000, 15 thought over 6,500, 8 over 6,000, while 7 saw a Dow below 6,000 and only 2 saw a Dow below 5,000.

* *

Nothing succeeds like *excess.* In the last three years 39 index funds have hit the market. This year alone Vanguard's Index Trust 500 (over $30 billion in assets) has pulled in an incredible $7 billion.

* *

Creation Story: This from *Jim Grant's Interest Rate Observer* (30 Wall St., NY, NY 10005): Consider "the gigantic hoard of Treasuries held in custody at the Fed for the accounts of foreign central banks. Two facts about this sum are especially striking: (1) its 22.3% year-over-year rate of growth; (2) its absolute size compared with the Federal Reserve Bank's own outright holding of Treasuries ($613.7 billion for the foreigners, a little less than $400 billion for the domestics). Under present-day dollar standards, as noted in this magazine before, the American current-account deficit becomes an engine of credit creation. Foreign central banks buy the dollar that overseas profit-seeking parties seem not to want. So doing, they create credit. And with their newly acquired dollars, the foreigners obligingly buy US Treasuries. If a new reader is wondering when this magical process will come to an end, so are we."

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Just got a letter from my old high school classmate, James Salter (West Pointer, Korean fighter pilot, well-known writer, novelist -- he wrote the script for Redford's classic "Downhill Racer"). Jim writes, "From about 1950, when I became aware, the biggest things that have taken place seem to me (1) the tremendous, almost unimaginable, accumulation of wealth, the fortunes made, and (2) the transformation or perhaps *destruction of the culture."* **Russell comment:** Harsh observations, but it's hard to argue with them. Actually, I don't think I've ever seen such emphasis, such fascination, with wealth as we see today. The heroes of the nation are Gates and Buffett. The magazines are bubbling over with stories about latter-day millionaires. Financial magazines fill the news-stands with blaring covers regarding how you too can get in on the Wall Street largesse. Donald Trump is back, the stock market is reaching for the sky, movies are judged on their gross, and we have a president who will take money any way he can get it.

* *

All of Hollywood is smarting, debating or complaining over Michael Ovitz's rumored parting payout from Disney, which will amount to $75 to $90 million for 14 months of work, work which produced little if anything. Making it even more embarrassing for Disney, the Mickey Mouse company tends to pay it employees less than most other Hollywood studios. Nevertheless, I see the whole situation a bit differently; let's call it, "That's capitalism." Ovitz was considered the "most powerful man in Hollywood," and it required a fat package to hire him. Had Ovitz been successful at Disney he would have been considered well worth the money. As it happened, Ovitz flopped at Disney, and so his rumored parting package, plus his options, seems outrageous. Of course, Hollywood is a town where everyone hopes you fail. But wait -- it now seems that the whole Ovitz parting package story may be a fabrication, possibly planted by Ovitz publicity agents. The real story -- it's not known at this time, honest.

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Almost every nation in the world is trying to increase its export sales. One way of doing this is to cheapen your currency. The process is known as competitive devaluations. Japan recently drove the yen down to the point where the dollar had increased nearly 40% against the yen. The latest participant in the devaluation game is South Korea. Two weeks ago the S. Korean won plunged to its lowest level against the dollar in 10 years (843 won to the dollar). S. Korea's current account deficit is up 86% this year over last -- to $18.6 billion. Economists expect the shortfall to reach $22 billion by the end of the year.

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I've written in many previous Letters that the **deficit** figures the government gives us are a lie. For instance, the actual additions to the national debt have been in a rising trend over the last six months. The latest figure shows that over the past 12 months **$299** billion have been added to the national debt. That $299 billion is the true deficit. So nothing has changed; it's only being hidden by the government's policy of grabbing the Social Security surplus. The fact is that we're adding almost a billion dollars a day to the national debt.

Ironically, even while the government has claimed that it has "reduced the deficit," the fact is that total government (city, county, state, federal) is taking a record amount in terms of taxes as a share of the national product. Actually, if you are a big earner and live in a high tax state, you know that the total take out of your earnings amounts to about 50%. Or as I tell anyone who asks, "I'm just a government employee under another name." The biggest recent gainers in the tax take have been state and local governments. The tax bite of the states and locals was roughly 8.5% of the national product in 1959. By 1996 it had risen to 12.5%. Furthermore, as states gain more responsibility for programs such as welfare and Medicaid, their take is going to rise. Taxes, all taxes, are basically destroyers of capital and a depressant to all wage earners.

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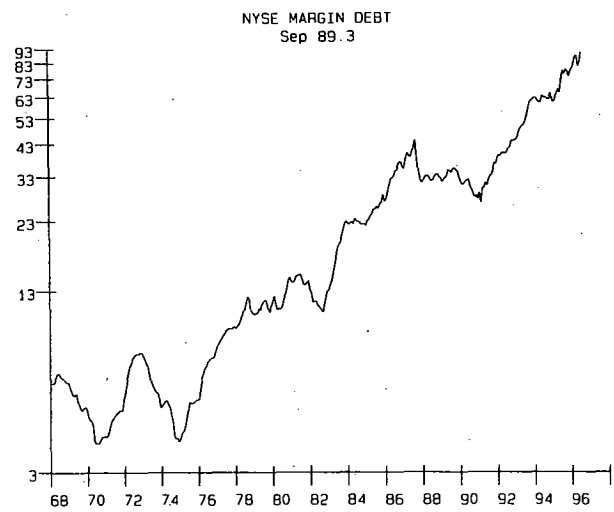
Margin debt tends to rise with a bull market. As a bull market progresses speculators become increasingly optimistic and consequently they borrow more. Finally, the bull edifice topples over, and as a bear market takes over and stocks fall, margin speculators close out their accounts and the margin accounts fall. At this point margins have seemingly grown to the sky as this chart suggests (chart courtesy of Ed Hyman and *ISI*). Note that since 1974, when the bull market began, margin accounts have surged higher in three major legs. My thinking is that the current leg is the final leg. When the bull market peters out, I expect margin accounts will embark on a long journey down. In the meantime, however, margins are at record highs ($93 billion) and seemingly pushing even higher.



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With China scheduled to take over Hong Kong in July of '97, politicians and statesmen of the world are watching the scene closely. Why? Because they're convinced that Beijing's treatment of Hong Kong's 7 million residents will tell a vital story. As the *International Herald Tribune* puts it, *"A successful transition that preserves Hong Kong as a bastion of free speech could serve as a model for China's own post-Communist transformation. A crackdown would seriously undermine China's hope of recovering Taiwan and jeopardize its own standing in Asia and around the world."* Incidentally, in a recent evaluation of over 130 countries, Hong Kong was placed at the top of the list in terms of political and economic freedom.

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The Germans are being accused of dumping cars on the US. The reason is the large differential in price between what German car manufacturers charge Germans and what those same cars sell for in the US. For instance, Mercedes' hot E420 which is soaring in sales in the US sells for roughly $6,000 less in the US than in Germany (even knocking off 15% for Germany's VAT tax). Every Porsche sold in the US is nearly 10 grand cheaper than the German list price.

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Noted liberal historian Arthur Schlesinger, Jr. polled 55 leading historians on the rank of US presidents. Presidents were ranked Great, Near-Great, Average, Below-Average and Failures. The greats were listed as Washington, Lincoln, FDR. Near-Greats were Jefferson, Jackson, Polk, T. Roosevelt, Wilson, Truman. Among Average were Eisenhower, Kennedy, LBJ, Ford, Carter, Reagan, Bush, Clinton. Failures were Pierce, Buchanan, A. Johnson, Grant, Harding, Hoover, Nixon. I disagree about Eisenhower. I would put him below average. I have never forgiven Ike for never confronting McCarthy. I would place Nixon above average -- paranoid as he was, he did open China to the US and the world. Clinton, I would put as below average. After all, what has he done but been unbelievably lucky. And I'm thinking that before his second term is over, his luck will run out. As for Kennedy, I always thought him below average. He talked a lot but never did anything that I was impressed with. On top of that, he stupidly attacked the steel companies in 1962, precipitating a stock market collapse.

* *

Language Fads: Gimme a break; I hate when that happens; I'm your worst nightmare; sorry 'bout that; been there, done that; yeah, right; don't even think about it; that's really special; you're toast; he's history; I'm outta here; same ol' same 'ol; I don't think so; it's a no-brainer; in your dreams; get over it; get a life; the bottom line; over the top; from the git-go; know what I'm sayin'; make my day. All these faddish, tired, cliché expressions, they creep into the collective unconscious of the nation -- then explode over the nation. Some remain, most disappear after a year or so. Do they make the language more or less interesting? I can't decide, but I know this -- once one of these fad-expressions becomes popular, it ultimately becomes annoying. Me, I prefer plain English.

* *

The first **political shocker** of '97 could be coming up when the case of *William Jefferson Clinton vs. Paula Corbin Jones* goes before the Supreme Court, probably early in the year. The *American Lawyer* publication (which I receive) outlines the possibilities. Excerpts: "This cover-up has been ably assisted by the leaders of the feminist movement who, in a craven reversal of all the pious pronouncements made in connection with Anita Hill and Bob Packwood cases, callously abandoned Paula Jones to the untender mercies of the President's men in order to secure his election . . . President Clinton has carefully avoided making any statements whatever, sworn or unsworn, about what, if anything, happened between him and Paula Jones. Instead, the President and his lawyers have exploited every delaying tactic at their command, including the pending Supreme Court appeal, to avoid confronting the evidence." **Russell comment:** And the evidence is very substantial, and it "includes clear proof, scattered through the public record, that the then-governor Clinton's state trooper bodyguard interrupted the then 21-year-old state employee on the job on May 8, 1991, and took her to meet Clinton, the boss of Jones, alone in an upstairs suite at Little Rock's Excelsior Hotel, for the apparent purpose of sexual dalliance." The rest, believe me, gets pretty raunchy, but in my opinion Paula Jones has a heck of a good case. If the Supreme Court says, "Go ahead with the case," WATCH OUT.

This from the *NY Times* magazine: "**Question** to Ben Stein, speech writer for Nixon: The post-election spirit of bipartisanship is vanishing fast. How bad will things get? Do you see President Clinton leaving office under a cloud of scandal? **Answer:** No, I worry about whether he will leave office when he's *supposed* to. He has shown such extraordinary contempt for the Constitution that I question whether he believes it applies to him. **Question:** Seriously? How would Clinton extend his term. **Answer:** He'd start by convening a task force to study repeal of the 22nd Amendment."

From Larry Klayman, director of Judicial Watch, a Washington watchdog group on the Clinton bunch: "To my knowledge, not in the 20th century have we seen the brazenness of an administration that is literally selling off any government service, any government commodity, for a price."

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Bob Packwood (remember him) is now lobbying all-out for a repeal of the hated estate tax. This tax accounts for less than 1% of all federal revenue, but its repeal is opposed by the Chamber of Commerce and the National Federation of Independent Business. Those favoring the tax claim the repeal is simply a special-interest gift for the wealthy. **Russell comment:** If a person accumulates wealth during his lifetime, what right has the state to claim a large chunk of that person's life savings at his death? Lovely, the state wants half of your earnings while you're working, more when you stop working and still more when you die. If they could tax you in heaven or hell, you can bet they'd do it. It's the old story -- the government is in the business of distributing wealth, not creating it.

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Hot dog, wife Faye, after six years at the law firm of Brobeck, Phleger & Harrison, has been made a partner. Brobeck is the fourth largest law firm in California with 450 lawyers; it is also second in the nation in handling Initial Public Offerings. So what now, should I retire and let Faye support me? I could get a dog (maybe a bull terrier) and an aquarium and just walk the dog and watch the fish. Nah, I'd be too bored. So I guess I'll keep doing what I like best. I call it wrestling with the market.

* *

If you want to make serious money be a partner in Goldman Sachs during a big bull market. For the third quarter of '96 the company made $793 million before taxes, and the 190 partners will receive $7 to $9 million each this year. The only catch is that the money stays with Goldman until the partner retires or splits.

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One of the young ladies who works for us told me she was going to Tijuana to buy Retin-A. "Won't it take an hour to drive across the border?" I asked. "No, I just walk across -- it takes me five minutes," she answered, "and there's a new shopping center just on the other side with two new drug stores." "Mmm, and what do you save," I questioned. "Well, it costs $35 to $65 for Retin-A here, and I get the same thing, same lab, for four dollars and sixty-five cents in Mexico." How can that be? Drugs are price-fixed in Mexico, so the drug companies sell to Mexico at a small profit. They make their real money here in the US. Conclusion: if you need a lot of expensive drugs or a medical treatment outlawed by the US courtesy of the FDA, move to San Diego. It's just 20 minutes to the border.

Speaking of San Diego (and I often do), the city was chosen as the third best place in the nation to find a mate (the other two were Atlanta and Phoenix). Why? Well, because *49% of San Diego's adults are single.* Wonder why? From my observation, people here just don't bother to get married; they just move in with each other (it seems to be a Southern California custom).

* *

Japan's going to see it all. Rupert Murdoch's News Corp. and Softbank, a Japanese computer and software distributor, plan to launch 150 channels of digital TV in Japan next year. Speaking of TV, I get both cable and satellite, and I don't see how cable, ultimately, is going to compete with satellite TV.

* *

You've got a great idea and you need money? At last count (1994) there were 38,807 grant-making foundations. Those foundations held $195.8 billion in assets, and they made grants of $11.3 billion that year. That's almost a billion dollars a month in grants.

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Las Vegas has become a theme park business. On New Year's eve, the Hacienda, a 1,000-room hotel, will be demolished to make way for a new 4,000-room complex, courtesy of Circus Circus. Then three days into the new year, New York, New York, a 2,000-room resort built as a scaled-down model of my home town,

will open. The next two years (barring a depression) we'll see a $900 million renovation and expansion of Caesar's Palace, the completion of Bellagio, a $1.25 billion project by Mirage Resorts, and Paris, a 3,000-room hotel planned by Hilton Hotels. In all, $6.8 billion will be spent on construction or expansion of 13 properties, and there may be more announcements to come. **Russell comment:** Las Vegas is a bargain if you just go there to eat and watch the people. But if you gamble (oops, game) it can be a very expensive vacation. Two things you can't get in Vegas -- newspapers and the time. They just don't want you to connect with the real world.

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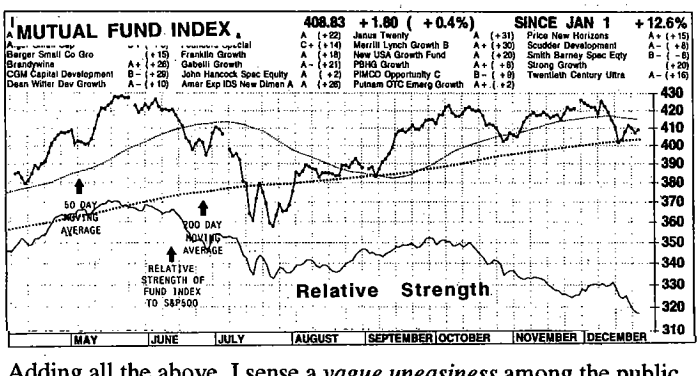
New York City? No that's not its name -- anymore than it's Chicago City or Denver City. It's the city of New York. Since the city and state have the same name, people got in the habit of calling it New York City to differentiate it from the state. Even the very proper *NY Times* occasionally refers to New York City. Wrong.

RUSSELL MUSINGS: The current situation is one of the strangest that I've encountered in better than four decades of watching the markets. Here's what I see. The market, by every valuation that I know of, is *expensive.* With the Dow selling at roughly 50 times its dividends, it's hard to argue anything else but "overvalued." On top of that we have all the warnings connected with next year, 1997 (see Investment Position). Now c'mon, Wall Street isn't stupid -- it's aware of the bearish cyclical, timing and overvaluation potential of '97, (and remember, '97 is a negative "decennial year").

The mutual funds have been a huge factor in this market, meaning that they constituted a huge source of *demand.* But the mutual funds are not finding it easy. This chart from *Investor's Business Daily* shows that the average of 20 leading growth equity funds is now lagging the market, with the high for the Fund Index having been recorded *last May.* Note that the relative strength line has hit a new low for the year -- no, it just hasn't been that easy for the funds.



Adding all the above, I sense a *vague uneasiness* among the public. Everybody "knows" this is a wild market, everybody knows that the market is expensive. So I term the mutual fund buying public hopeful, even bullish -- but *also nervous* and with their fingers crossed.

Why then does the public keep buying? They're buying for two main reasons. (1) They feel they have to own stocks to keep up with the rising cost of living. They don't believe Social Security will pay off, and that consequently, they have to provide for themselves. (2) They see the market continuing to go up, they see all their friends buying mutual funds, and it's the "lemming effect." People tend to join the crowd.

So we have a great many of the classic elements that characterize a great market top. **Except,** as I said, for the very subtle underlying nervousness of the public plus the *warnings.* The first real warning came from Fed Chairman Greenspan a few weeks ago. This produced a quick sell-off, but the Dow is now 100 points above the level corresponding with the Greenspan warning.

Then on Friday (Dec. 27) the authoritative *New York Times* in a front page article warned about "the rush" into mutual funds. The

Some Worries About the Rush Into Mutual Funds

Analysts Wondering What Will Happen if Markets Falter

By EDWARD WYATT

Encouraged by continued growth in financial markets, the number of American households investing in mutual funds has risen by more than 20 percent in the last two years, recent research shows.

But a growing share of the largest segment of that group — shareholders in funds that invest in the stock market — have never experienced a significant market downturn, raising questions among market analysts about just how they will react if there number of fund-owning households helps to explain the rapid growth of the mutual fund industry over the last two years, and provides support for those who argue that the sharp rise in the stock market has been aided by the floods of cash coming

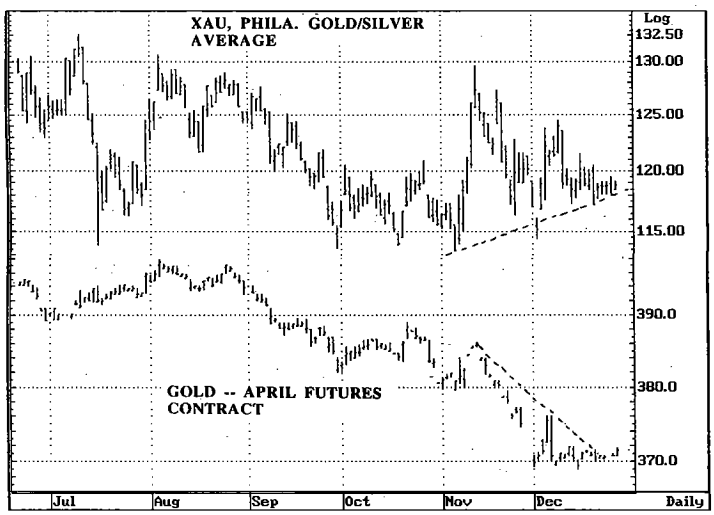
But the data also contain some ominous warnings. About one-fifth of all mutual fund owners made their initial investments within the last two years, and more than 60 percent of those buyers purchased equity funds. With the United States stock market not having experienced a decline of more than 10 percent in six years, what those new stock market investors will do when confronted with a downturn is uncertain.

Mr. Rea, the mutual fund trade group's chief economist, said he saw greater significance in the fact that

Times estimated that 63 million Americans now own funds, up 66% from four years ago. Considering that the population of the US is 266 million and that a lot of the population is under-age or at the poverty level, this means that a huge number of "average" Americans own funds. What happens, the article asks, if the market heads down?

And I ask myself, is this the kind of atmosphere one would expect at a major top -- questions, warnings, nervousness? In all honesty, it's a very strange situation. So I'm going to hazard a guess -- IF this market is near topping out, *we may first move into a frustrating trading range first.* The fact is that the advance-decline in the over-the-counter market is already near collapse (meaning that many stocks have declined). The A-D line on the NYSE is now lagging as is the A-D for the 30 Dow stocks.

The market has become *extremely selective* -- the Mutual Fund Index confirms this observation. The reason the Fund Index has not bettered its May high is simple enough -- too many stocks have backed off or not kept up with the big averages. Which tells me that **in '97 it's going to be hard to make money in stocks, and easy to lose it.**



GOLD: Volatility in the yellow metal is at its lowest in decades. But "after the calm comes the storm." Somewhere ahead, there's a storm. When it arrives, gold will again have its day.

As to what's currently happening in the world of gold, the chart says it all. Gold, the metal, has been in a long downtrend, but, during December, gold moved sideways in a tight trading range. Note, however, that XAU, the Gold/Silver Average, turned up in November, and has been diverging with the metal. Is this significant? Is something finally stirring in the world of gold? Can't tell yet. An observation -- historically, gold and gold shares tend to record their lows in the fourth quarter of each year.

FINALLY, SEASON'S GREETINGS TO ALL MY SUBSCRIBERS. MAY I WISH YOU HEALTH, EQUANIMITY, WISDOM, SELF-FULFILLMENT AND PROFITS (IN THAT ORDER).

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